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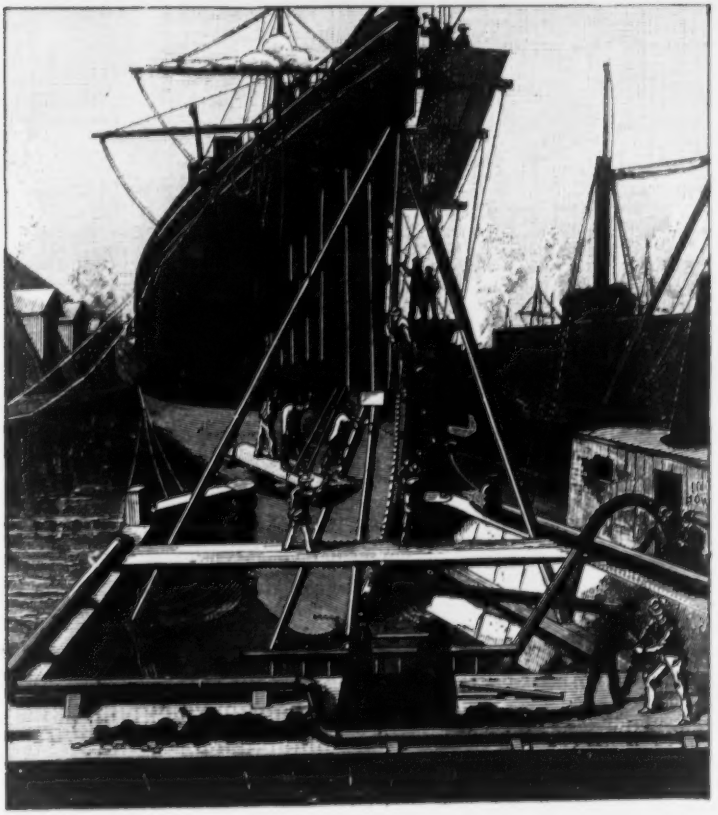
Economic Times



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Editor's Note

This being the first month of the quarter, we offer our usual Industry Outlook Report (shaded center section)—a look at economic prospects for seven important industries. Next, drawing on three of his recent *Letters*, our Conference Board compatriot, Al Sommers, reviews the long-term outlook for the U.S. economy from a variety of interesting angles.

Then we hear from another cherished friend of long-standing, Paul McCracken. I love his use of "disestablishmentarianization," the process by which new ideas and new products are tested by the impersonal referee known as the marketplace and then, if successful, compete old ideas and old products out of existence. (And you thought it was only an answer to the trick question, what's the longest word in the dictionary!!)

We also have Owen Harries discussing the tension and hostility that accompanies migration, and our faithful Colloquium panel tackling inflation. And as always, we provide perspective on the U.S. near-term outlook in our Stat File and Crystal Ball. Finally, this being tax month, the maxim below should remind us *not* to complain about paying income taxes.

Ed Fiedler

Maxim of the Month:

The one thing that hurts more than paying an income tax is not having to pay an income tax.

Thomas Robert Dewar, 1864-1930,
British distiller and raconteur

A Close Race?

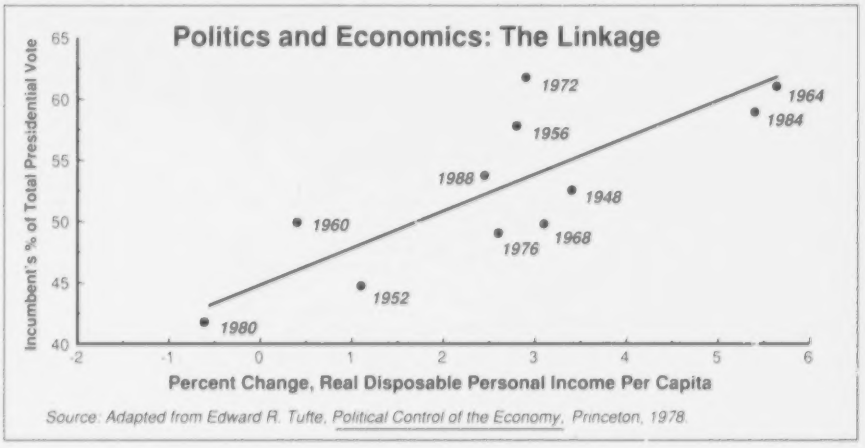
Among political analysts, it is an article of faith that defeating the re-election bid of a sitting Republican President is, absent recession or scandal, an extremely difficult undertaking. Well, maybe not. The relationship charted below, first examined by professor Edward Tufte, tells us that if real after-tax income per person is rising at better than 2 percent per year, then the candidate from the incumbent party is likely to be elected. Below 2 percent, the "out" party gains the advantage.

Since Tufte, this simple relationship has further proved itself. The 1980, 1984 and 1988 observations on the chart all fall very close to the diagonal line, confirming the importance of economic performance as a reliable indicator of which way the vote will go.

What does this portend for Mr. Bush's chances in November? The economy is recovering, yes, but perhaps not fast enough to give the in-party candidate an edge. The common forecast calls for real after-tax income per capita to increase between zero and one percent this year. Historically, that's not enough for the Republicans; zero to one percent income growth corresponds to a 45 to 48 percent vote for President Bush—a clear loss in the popular vote.

The predicted margin is not overwhelming, however, and many things could undermine the forecast. The economy could be stronger than now predicted. On personality or character grounds, one candidate may prove to be much more attractive than the other, as for example Eisenhower proved to be in 1952 and 1956, when he won by substantially larger margins than indicated by income growth. Furthermore, being the incumbent President himself, as Bush is, could be a much greater advantage than simply being the candidate of the party that previously held the office (which is the basis of the relationship used here). For any of these reasons, and others, the election could turn out much different than now signaled by the economic outlook.

For now this year's contest looks like a fairly close race that could go either way. But if, as expected, income growth remains below par in 1992, the election would appear to be an uphill battle for President Bush.



Source: Adapted from Edward R. Tufte, Political Control of the Economy, Princeton, 1978.

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Colloquium: Inflation Policy

Background

One of the few blessings of recession is the reduction it brings in inflationary pressures. Currently, although not vanquished, inflation is clearly subdued. The advance in consumer prices excluding food and energy (the so-called "underlying" or "core" rate of inflation) has subsided to around 4 percent in early 1992 from about 5 ½ percent a year earlier. Wage pressures have also eased.

Question

As the economic policymakers look ahead to the next and presumably more satisfactory stage of the business cycle, what should their goal for inflation be?

Stephen H. Axilrod
Nikko Securities International

Central bankers have a great tradition,
Zero inflation's what they are wishin.'
But twixt wish and deed,
There's economic need,
Like growth that's to be saved from perdition.

Think zero if you must,
Two's as good, also just.
Three may squeeze through the door.
Perhaps four, but no more.

Andrew F. Brimmer
Brimmer & Company, Inc.

Economic policymakers should not forget about the problem of inflation. After all, a 4 percent rate of inflation cuts the value of financial assets by one-third over a ten-year period. The Federal Reserve should not seek a zero rate of inflation. However, to prevent rekindling inflation expectations (which would push up long-term interest rates and dampen capital outlays), it should restrain the expansion of money to a rate roughly in line with the economy's long-run growth potential.

Don R. Conlan
The Capital Group, Inc.

Assume no surprises—no oil shock, no big drop in the dollar, no budget-busting, and no money (M2) growth outside the Fed's current target range. Also assume the service sector gets productivity results from its current misery. Cyclical productivity growth should then be strong enough to keep the underlying rate of inflation below 3.5 percent for some time. That's not zero but it's pretty low and should produce lower long-term interest rates. So relax, already! Let's have a little growth!

John T. Dunlop
Harvard University

Economic policymakers do not act in concert on measures affecting inflation rates. There are many goals, and inflation constraint is not uniformly cherished over employment, credit availability, agricultural policy, public projects, or controls on health care costs, particularly in an election year. With little increase in nonfarm business productivity and with wages, salaries and benefits rising in the 4-5 percent range, policymakers are likely to accommodate the resulting inflation rate including the effects of import prices.

Members:

Members of The Conference Board Economics Colloquium are: Stephen H. Axilrod, Vice Chairman, Nikko Securities International; Andrew F. Brimmer, President, Brimmer & Company; Don R. Conlan, President, Capital Strategy Research; Robert G. Dederick, Executive Vice President and Chief Economist, Northern Trust Company; John T. Dunlop, Lamont University Professor Emeritus, Harvard University; Gail D. Fosler, Vice President and Chief Economist, The Conference Board; Lyle E. Gramley, Senior Staff Vice President & Chief Economist, Mortgage Bankers Association; Isabel V. Sawhill, Senior Fellow, The Urban Institute; James Tobin, Sterling Professor Emeritus, Yale University; Laura D'Andrea Tyson, Professor of Economics, University of California, Berkeley; Charls E. Walker, Chairman, Charls E. Walker Associates; Murray Weidenbaum, Director, Center for the Study of American Business; Albert M. Wojnilower, Senior Advisor, First Boston Corporation.

The Troubled Trend

by Albert T. Sommers

The *feel* of the U.S. business cycle at the start of 1992 is different from the usual historical pattern. This is not just a matter of the feeble recovery from the 1990-91 recession. What is at issue is the strength of the substructure of the U.S. system that controls its longer-term growth potential.

The conclusion reached here is that accumulating changes over the past 10 years have precipitated a general decline in the growth rate of the economy as a whole. The distinguishing feature of the recent recession is not pronounced cyclical weakness; as recessions go, this one was relatively mild. But the trend rate of growth is a different story. It is a striking fact about recent economic performance that U.S. output falls below virtually any trend value constructed from U.S. experience since 1960. If real output were to increase 1 percent in 1992 and 3 percent in 1993, a projection not far from the current consensus, the four-year growth rate for 1989-1993 would be a dramatically low 1.1 percent.

The Labor Force and Productivity

Arithmetically, growth is a product of the number of people at work and the output achieved per person. The civilian labor force, as the accompanying chart shows, has been falling, relative to trend, for many years. In 1991, the actual labor force fell almost six million workers short of the 1970-1990 trend.

More important than the crude supply of labor is its quality, training and skills. The United States is disadvantaged, in the sense that its average literacy and educational levels are deficient relative to its major international competitors. Thus new labor-force entrants are poorly equipped for the increasingly technical jobs that are replacing low-level clerical and physical jobs—an obvious threat to productivity performance.

With respect to productivity, the statistics again suggest caution beyond the issue of a skills mismatch. The U.S. structure remains heavily consumption-oriented; its saving and investment ratios are significantly lower than those of its international competitors. Pessimism on this subject can perhaps go too far; in manufacturing, the productivity gain in the United States in 1989-91 was generally good. But the inclusion of service industries in the aggregate productivity measure produces deplorable total performance—a trend rate of 1.1 percent since 1984, and zero net change since 1988. The saving and investment expansions required to elevate this performance are not by any means discernible yet (see chart, p. 5).

A Laboring Government

With respect to its bearing on the growth potential the government sector has temporarily exhausted its capacity to provide energy to the private sector. The cuts in the defense, unequivocally beneficial long run, are bound to produce dislocations and adjustments throughout the defense sector for many years ahead.

Source: U.S. Dept. of Labor; The Sommers Letter

The opportunities to convert this decline in outlay into a stimulative decline in taxes are obstructed by the size of the aggregate deficit, and by the continuing uptrend in transfer-type outlay. This circumstance applies with equal force to state and local governments, whose aggregate employment is five times that of the Federal government, and which we should expect to be in a period of consolidation for the next half decade. Thus the constraints on government seem to impose a limitation on the growth prospects of the system as a whole.

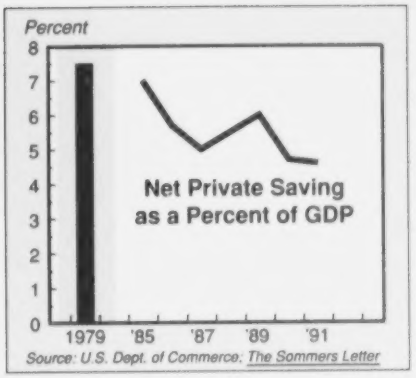
The Political Impasse

In the presence of prolonged sluggish growth, the social issues to which government addresses itself have congealed into a tough, hard-shelled mass. One such issue is the prolonged slow growth in most incomes, which has generated a broad definition of a middle class that has been disadvantaged and merits favorable tax consideration; while below that class in the income distribution is now an "underclass" still more urgently in need of governmental assistance.

More important issues are the still inchoate state of the debate on health insurance and the continuing negative information on the quality of education. But the tendency of voters to place very high priorities on such programs, as well as on drugs and crime, is not now matched by their willingness to finance increased participation of government efforts in these areas, and the political leadership (as well as the money) required to face up to the costs realistically is lacking thus far in 1992. The weakened political posture of government, moreover, disposes it toward politically inspired concessions that are not in the interest of long-run growth.

Private-Sector Considerations

On the demand side of the system, U.S. prospects also carry inhibitions.



Throughout the 1990s, domestic demand will be contained in some degree by demographics—a very low household formation rate affecting the underlying vigor of housing and consumer durables. These demands and others are also affected by the abnormal levels of private debt generated in the 1980s. Excesses in the commercial construction market will weigh heavily on that sector for several more years; and the overhang of housing inventory held by the RTC militates against strong gains in residential construction. Finally, real interest rates in the United States remain abnormally high, which is also a substantial consideration with respect to both housing and inventory demand.

These observations on the condition of consumption spending in the 1990s are certainly inconclusive. But in conjunction with other troubles of the long-term trend described here, they carry mild and uncertain corroboration of the conclusion that growth in demand in much of the 1990s will not approach the rate achieved in much of the 1980s.

The Social Burden

In the 1990s the U.S. economy is living with a rising burden of "social costs," much more pronounced in the United States than among other developed nations. This burden continues to grow and spread. Public spending for "social welfare" now totals about $1 trillion, and is rising at $50 billion a year. This includes all social insurance, public aid, health and medical programs, veterans' programs, educational outlay, and housing outlay. Other costs confronting the system include an "underclass" —an under-educated, unproductive, ill-housed, dependent, largely untaxed population, prone to drug and alcohol addiction and crime—that is difficult to describe, difficult to measure, difficult to treat, but which surely stands in the way of vigorous economic growth.

These issues, taken together, pose a great American dilemma. Failure to treat them will perpetuate them as a limit to growth. But aggressive treatment of them would cost a vast multiple of what the American political process now seems at all likely to deliver.

The Ethical Burden

The ethical issue here is not the American "work ethic" so assaulted by Japanese politicians and businessmen. The U.S. work ethic among those integrated into the ongoing work force seems entirely reputable and appropriate. The issue here is the "public ethic"—the widely accepted ethical practices and standards that preserve social order, and support respect for public authority and the rule of law itself. An ethical system in deterioration carries heavy costs for the productive part of the system, in elevated security requirements, environmental costs, tax evasion, growth of the underground economy, and the costs of crime ranging from pilferage to financial and public fraud.

The weakened political posture of government disposes it toward politically inspired concessions that are not in the interest of long-run growth.

The erosion of family structures multiplies educational costs, crime costs, drug costs. The intense search for individual protection against risk, regardless of the social costs, drives environmental and product-liability regulation to extremes. Relaxations of a public ethic compromise support for public programs that deal with equal opportunity, education, early family environment.

These conditions are, of course, always present in some degree, human beings being human, but they appear to be far more than normally present in the early 1990s, after a decade during which public responsibilities were so subordinated to the search for personal success in private markets. Of all the reasons for expecting slow real growth for several years ahead, these concerns, whose connection to economic growth itself defies the methods of economics, may turn out to be among the most important of all.

Conclusions

All of these issues can be condensed into three major descriptions of the drain on long-term growth. First, the system is emerging from, but continues to be dominated by, a hangover of the "bubble-economy" of the 1980s.

Second, the consumption orientation of the U.S. system continues to dictate inappropriate decisions with respect to taxes; for example, proposed reductions in personal taxes, the failure to increase oil taxes, the failure to legislate value-added taxes, and failure to finance a considerably higher level of public and private investment, when the need is clearly accumulating.

Finally, the social and ethical issues described here, and their effects on the political process, are deep-seated and long-term. The costs of a deteriorated public ethic are impossible to measure, but very high with respect both to our own past record and to the current records of our competitors. As the world's largest multi-racial, multi-ethnic, multi-class society, the United States requires a degree of leadership as great as any nation in the world; it will take very high leadership indeed to rebuild a public ethic consistent with rapid and sustained long-term economic growth.

Albert T. Sommers is Senior Fellow and Economic Counsellor at The Conference Board.

Disestablishmentarianization and Democracy

by Paul W. McCracken

For a system to generate progress there must be freedom for unlikely ideas from unlikely locations to have a go at it.

A giant question mark hanging over the world economy is whether the erstwhile government-managed economies of eastern Europe and the former U.S.S.R. can successfully metamorphose into liberal, market-organized systems. We are clearly seeing here a convulsive effort in history of nothing less than Homeric proportions. On its success depend the hopes of those people for a sustained and widely diffused rise in their material levels of living.

Moreover, it is clear from international experience that political democracy and a state-managed economy are incompatible. No country has both. The yearnings of these people for democracy can only come to fruition if they can make it to a liberal, market-organized economic order. (This statement is not, of course, reversible. A market-organized economic system does not assure democracy, but it is a necessary condition.)

We now understand why the liberal economic order turns in a better performance. First, it can make use of an aggregate of knowledge and creativity not found in its totality anyplace. New ideas for something new and better usually emerge from the most unlikely places. The modern calculator did not emerge from those who made slide rules. Wagon and carriage manufacturers did not bring us automobiles. For a system to generate progress there must be freedom for unlikely ideas from unlikely locations to have a go at it.

Second, the new must be tested out by the impersonal refereeing of the marketplace. If the new is better, it competes the old out of existence—this no matter the frowns of manufacturers or bureaucracies who have grown comfortable with the old. The liberal economy has a process for continuing and systematic disestablishmentarianization, and the process is central to progress.

Third, an economy delivering vigorous progress is not a secure place. Old, tried-and-true skills and professions and businesses are in danger of finding themselves out of the ball game, replaced by the new and better that came from an unexpected direction. This does not mean that the rapidly progressing liberal economy has large unemployment. Productive resources get shifted to new and better uses. The unemployment rate for the first three decades of this century, a good period for the U.S. economy, averaged 4.7 percent, and for the quarter of a century from 1948 to 1973 the rate was 4.8 percent. Indeed, it is the dynamic economy with strong rates of economic progress that is apt to have low unemployment rates, and it is the slow-moving, sclerotic economies that tend to have the most troublesome unemployment problems.

Questions About the Transition

This all poses three central and interacting questions about the ability of the eastern European and former U.S.S.R. economies to make the transition. Will the governments, including importantly the bureaucracies, be willing to accept the reduced role that is essential if a market economy is to work? This disinclination may range from not finding it credible that something will happen unless there is a diktat from some government bureau, to simple unwillingness to give up prerogatives and power.

Second, and this may be the most difficult problem of all, will the citizenry in those countries accept the trauma and messiness that will be involved during a transition that may extend over a period of several years? Out of sheer exasperation and desperation, and with encouragement from an officialdom and bureaucracy whose status is reduced in a liberal economic order, there could be a convulsive 180 degree turn about to the old system. Moreover, the

(Continued on p. 7)

Industry Outlook Report

Overview: Unexciting Upswing

Edgar R. Fiedler
The Conference Board

This latest round of reports from our distinguished panel of industry specialists shows a solid pattern of moderate growth prospects across all seven industries. Only one of our analysts—for general merchandising—is still unconvinced that a cyclical recovery is underway. And even he, joined by our other more cautious contributor, for motor vehicles, expect a slow recovery for their industries in 1992.

Three other analysts emphasize the company-by-company diversity of prospects. In banking the key is location: In many cases even a vigorous national recovery will not offset losses from regional credit problems. In chemicals, the key is the firm's product portfolio. Profits of bulk-petrochemical producers are hurting because their selling prices are under pressure, whereas the "value-added" producers benefit from low input costs. Among the airlines the key is having enough domestic hubs tied to comprehensive international routes. The carriers that survive, we hear, "will show the best airline performance ever," because "the profit-killing wars are nearly over."

The two industries in this report with the most favorable outlook are business services and capital equipment. Neither analyst is highly optimistic but both expect solid gains in output in 1992 and 1993. Our specialist in business services calls for growth there to outpace the other service sectors. Even stronger, capital goods are expected over the next five years to "show the best growth of any major sector of the U.S. economy."

One factor supporting capital equipment—in both the recession and the continuing recovery—is exports. The same point was made for the chemical industry, except with more caution about the year ahead. On the other hand, this time around none of our panel expressed any worries about inflation.

In summary, if reality follows our forecasts, it all adds up to nothing fancy, nothing exciting, just a steady recovery at a moderate pace. But is there anything wrong with that? If our social safety net had fewer holes in it, not much at all. Always welcome.

Capital Equipment: Solid Gains Ahead

Adrian T. Dillon
Eaton Corporation

Capital equipment is in the initial stages of recovery from recession. Last year, U.S. equipment purchases fell 3½ percent (real), about one-third the average decline in previous recessions. Information processing equipment was—despite the headlines about restructuring at IBM and other high tech companies—the major source of strength. The "problem" for this industry is that, with prices falling 5 to 10 percent per annum (15 percent for computers alone), a 7 percent increase in "real" purchases—a boom elsewhere—translates into flat or declining revenues and imploding profits. The industrial equipment sector took it on the chin, falling 6 percent in 1990 and an additional 12 percent in 1991.

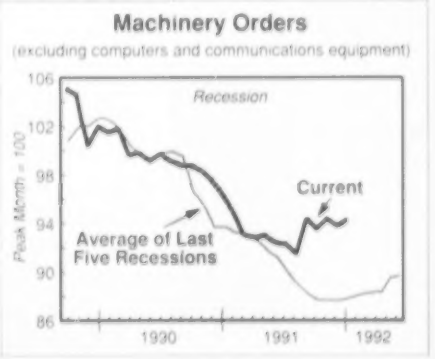
With real GDP rising modestly this year and a bit more respectably in 1993, capital equipment should play its traditional accelerator role. Information processing will be supported by deliveries of a new generation of IBM mainframes and by the continuing revolution in computing technology. Industrial equipment follows capacity utilization very closely, and thus should rise just a little this year and more strongly in 1993. (See table for details.)

Capital Equip. Purchases (pct chg)

	1991p	1992p	1993e
GDP	-0.7	2	3.5
Cap. equip.	-3.5	8	8.5
Info. proc.	7	11	10
Aircraft	10	10	0
Ind'l equip.	-12	2	8
Autos (mil.)	12.3	13.5	14.3

These numbers probably look surprisingly favorable, but it's likely that *shipments* of capital equipment will do even better than purchases. As the chart shows, shipments of industrial equipment fell less than usual during the recession and have been rising since last August. The reason is foreign trade. Total capital goods exports rose 10 percent last year, despite recessionary conditions in much of West Europe and a slowdown in Japan. Thus, while U.S. *purchases* of equipment fell 3½ percent last year, U.S. *shipments* of capital goods dropped only 1.6 percent.

A gradual recovery in the U.S. and Europe, sustained strength in East Europe and Asia, and building momentum in Mexico and Latin America suggest that total U.S. shipments will rise over 9 percent this year and again in 1992. Over the next five years, capital goods should show the best growth of any major sector of the U.S. economy.



Business Services: Up But No Major Takeoff

Joseph W. Duncan
Dun & Bradstreet

Employment statistics are probably the best single statistic to examine what's happening in business services. Expenditures for business services are neither consumption nor investment. More traditional sources of information such as the National Income Accounts, production, productivity or foreign trade statistics simply do not explicitly recognize business services as a component.

Business services include such diverse areas as credit reporting, advertising, and data processing. Unlike many other sectors of the economy, most business service functions can either be performed "in-house" or by other firms. This has contributed a great deal of volatility to the sector.

Employment in the service sector has grown faster than overall employment in each year since 1966. Since then, growth in business services employment exceeded service sector employment growth in each year except 1971, 1975, 1982, and 1991, all recession years. Following each of these years, business services employment bounced back sharply. During the 1980s, business services employment growth averaged a whopping 7.6 percent annually, versus a still-healthy 4.7 percent for the entire service sector.

Thus, business services are highly sensitive to the business cycle, but on a higher plane of growth. When a recession hits, firms first attempt to perform an increasing number of business service functions on their own, reducing their expenditures on other firms' services. For example, an accountant may wear the hat of a credit manager. However, the need for business services always remains. Toward the end of a downturn, businesses resume their purchases of these products when more resources are available.

This is what we are seeing currently. In 1991, business services employment grew 1.2 percent. Within this sector, credit reporting firms added 4.9 percent to their payrolls, advertising employment fell 2.5 percent, but computer services staffing levels increased 6.4 percent. At the end of last year, the trend was up in most areas. A major takeoff of business services employment is probably not in the cards for 1992, but growth in this area will definitely outpace growth in other service areas and the economy as a whole.

Chemical Industry: Reasonably Healthy Growth

A. Nicholas Filippello
Monsanto Company

The U.S. chemical industry's fortunes this year will be closely tied to the health of the U.S. and world economies, and particularly to key end-use markets. The most important of these are automotive vehicles, construction, agriculture, packaging and consumer purchases of carpeting, appliances, home furnishings, apparel, cosmetics, soaps and detergents, pharmaceuticals and food.

Based on the consensus view of a slow upturn in the English-speaking economies, a weakening in Germany and Japan, and a general convergence to growth averaging some 2-2½ percent over the next year, the chemical industry can be expected to experience reasonably healthy annual volume growth over 1992-93 of 3-4 percent. Latest signals in the United States suggest the long-awaited upturn may be at hand.

Because it is international, the chemical industry is critically affected by worldwide economic trends and oil and gas prices. The U.S. industry has developed a strong international trade surplus, even as production in basic petrochemical capacity has grown around the world. The principle international strength has been in the high value-added and high technology end of the market, including pharmaceuticals, high performance materials and specialty products. This reliance on international markets has been a source of strength during the recent U.S. recession. However, it could also limit the recovery over the coming year as economic growth outside the U.S. slows.

Company prospects differ depending on the product portfolio of a given firm. Producers of bulk petrochemicals will benefit less from economic recovery than "value-added" producers. This is because petrochemical capacity is increasing and hydrocarbon prices are weak, which means commodity producers are realizing relatively low prices while value-added producers benefit from low input costs.

The industry is going through another round of restructuring and downsizing. This will lead to cost reductions and productivity enhancenients that will significantly increase profit margins once capacity utilization rates rise back into the low-to-mid 80 percent range. Profit growth will be moderated, however, by the costs of environmental compliance.

Auto Industry: Slow Recovery

Donald P. Hilty
Chrysler Corporation

Since the beginning of 1990, U.S. car and truck sales have tracked below trend. Sales shortfalls early last year were as severe as during the 1982 recession. In the past 12 months, sales have zigzagged around an annual rate of 12.5 million units—a pace lower than expected in an "average" recession. The auto industry can build 6.9 million more cars and trucks in North America than it can sell; that is one-half million *more* unused capacity than in 1982.

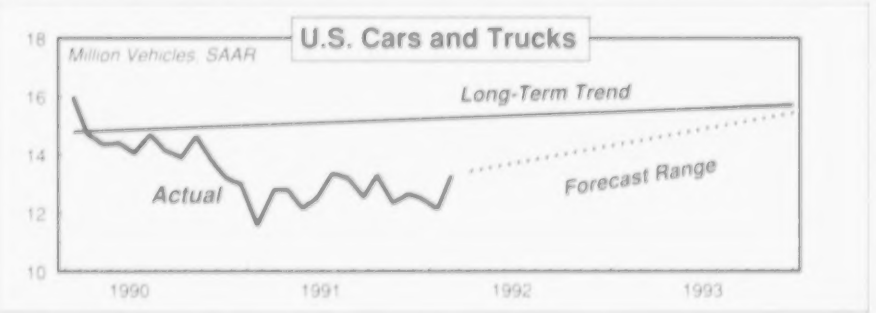
But the stage is being set for a recovery. Auto installment debt declined last year, the first time since 1958, by over $13 billion. Less profitable sales to daily rental companies have been cut back and are approaching the normal two-a-year pattern. Inventories are back to normal seasonal patterns in terms of days supply. And showroom traffic is running 5 percent better than a year ago, while the sales closure rate is up 4 percent. Sustained improvement in the sales pace would quickly trigger increased production.

However, most auto analysts, reflecting the consensus forecast of only modest overall economic growth, expect this auto industry recovery to be the slowest since World War II. Car and truck sales should total around 13.5 million units this year and perhaps 15 million next year. At these rates, sales would not approach trend until the end of 1993. The domestic industry has cut costs dramatically, and continues to do so, in order to break even this year and return to respectable profitability next year.

U.S. Car & Truck Industry Percent Change

	Unit Sales	Profits
	year-to-year percent change	
1990	-4.7	-88
1991	-11.4	Record Losses
1992e	8.0	Breakeven
1993e	11.0	Respectable Profits

Thus the auto industry is basing its operations on a very slow recovery. We may be pleasantly surprised, however, because industry sales have increased 15-20 percent in the first year of the past five auto recoveries, regardless of GDP advance.



Financial Institutions: Major Challenges

Karen N. Horn
Bank One, Cleveland

Financial institutions underwent major changes in the 1980s and face more major challenges in the future. Domestic banks have been losing market share to both nonbank competitors and foreign banks. From 1975 through 1990, U.S. bank's share of commercial and industrial loans fell from nearly 71 percent to under 50 percent. More dramatic is the decline in bank's share of short-term credit to large corporations. This share fell from 50 percent in 1975 to around half that by the end of the 1980s. Bank's share of consumer loans has fallen as well, as nonbank competitors have successfully made inroads into this market.

Increased competition from unregulated competitors combined with outdated regulation has increased the vulnerability of banks to changes in economic conditions. Branching restrictions have effectively limited geographic diversification, creating a greater vulnerability of banks to regional economic conditions. The large number of insolvent thrifts that operated throughout the 1980s had a corrosive effect on net interest margins for both banks and thrifts and contributed to a speculative run-up in real estate prices in a number of regions. Banks themselves misstepped as they overbooked real estate, energy, and LBO credits. The result has been a sharp increase in nonperforming loans and increasing bank failures.

The Outlook. Banks face a number of challenges over the next several years. Near term, the banking industry must both downsize and recapitalize. An important element of the restructuring is comprehensive legislative reform of banking regulation. The industry has had some recent success in issuing new equity in capital markets, but it is not clear this trend will continue without fundamental changes in bank powers that will enable banks to earn high enough returns to attract new equity. Signs that the national economy may be in the early stages of a recovery are positive for banks in general. In many regions, however, banks still face an uncertain and difficult future because the national economic recovery will do little to alleviate the regionally-related credit problems in their portfolios.

General Merchandise Retailing: Despite Gloom, Gradual Recovery

Walter E. Loeb
Loeb Associates Inc.

January and February were great months for many retailers. Sales increased substantially, and profits were up even more. The reasons are simple. First, last year an apathetic consumer focused on the war in Kuwait and spent little, so this year comparisons were easy. Second, retailers over the past two years have tightened their staffing drastically in order to lower costs. Thus, current sales increases are being translated into profits. These traditional optimists are not yet, however, loosening their purse strings for either staffing or inventory. They are still not convinced that an economic recovery is in place.

Neither am I!

The consumer remains very cautious. She shops late, when she needs something, not when she simply wants the item. Shopping for an event or a holiday is done at the last moment. The demand for value also remains; the consumer wants to buy on sale, at a discount or wholesale, whatever it takes to stretch the family budget. Discount stores should continue to benefit from this attitude.

Consumers are worried. First of all, they worry about employment; too many friends are out of work. The unemployment rate will probably remain around 7 percent throughout 1992. Consumers are also concerned about their own careers. With cutbacks in the industrial sector, there are fewer promotions, fewer bonuses, even fewer salary increases. Consumers also continue to worry about high taxes and health care costs.

In spite of this generally gloomy view, the action of the stock market has encouraged the more upscale consumers. Thus, specialty store and department store sales should gradually improve in 1992.

I look for a slow recovery in the economy through most of 1992. For the full year, I estimate real GDP will increase 2.8 percent with inflation rising 3.5 percent. For general merchandise, I project a 2.3 percent gain in real terms, 5.7 percent in nominal terms. Much of this gradual recovery should come in the second half of 1992. If housing starts continue to accelerate and if capital spending also has some bounce, my estimates may need to become more optimistic.

Airline Industry: Bright Outlook for Large Carriers

George James
Airline Consultant

Three major carriers died last year (Pan Am, Eastern and Midway). Three have double pneumonia with temperatures over 105 degrees (TWA, Continental, and America West). Two have the walking flu (US Air and Northwest). The remaining three largest airlines (United, American, and Delta) have head colds that will soon go away. Two others, Southwest and Alaska, have remained relatively healthy because they took preventive medicine and stayed away from the climate of the others, a condition likely to continue.

All of these illnesses came about because of the Gulf war, sharp fuel price increases, the U.S. recession, and heavy price cutting by the weakened airlines. Taken together these adversities brought about nearly $5 billion in net losses in 1990 and 1991, more than airline total net profits since World War II.

The results: Over a thousand planes have been grounded, tens of thousands of employees are out of work, $10 billion of aircraft orders and options have been canceled, and investment sources for equipment financing have essentially vanished.

In the future, only the large airlines—whose with numerous domestic hubs tied to comprehensive international routes—will be significant carriers. American, United and Delta are in this group. Among the rest, one or two amalgamations might be formed by taking the best of each and shedding all else, including high labor costs and restrictive work rules.

Financially, the worst is over. In 1992 the industry can be expected to make a small profit—less than one percent operating margin or about $500 million on nearly $80 billion of operating revenue. Then, as fares rise more in line with inflation—something not possible in the past when many airlines often priced below costs—the remaining carriers will show the best airline financial performance ever. Recent proposals to raise discount fares by 2 percent are indicative of this trend.

The U.S. airlines are famous for volatile profit performances but this time they will rise to new heights and, surprisingly, stay at those profitable levels for the indefinite future. The profit-killing wars are nearly over.

U.S. Airline Industry Operating Results

	1990	1991p	1992e
Revenues ($ bil)	76	74	78
Profits ($ bil)	-2.0	-2.0	0.5
Profit Margin (%)	-2.5	-2.7	0.6

key prime-mover in a liberal economy is the entrepreneur. If the entrepreneurs are doing their job, they will be the affluent citizens of their nation, and it may look as if decades of propaganda—that these "capitalists" get rich by appropriating what belongs to ordinary people—is correct.

Most difficult of all, will the citizenry in eastern Europe and the former U.S.S.R. accept the trauma and messiness that will be involved during a transition.

The final question is whether the people will accept the greater and more mature responsibility for their own destiny that is inherent in a liberal, market-organized economic order. The liberal economy will deliver more rapid progress, but the fortunes of any individual or profession or business are inevitably more insecure. And unease about such insecurity will be compounded by the inevitable disarray of the transition.

No Alternative

We can, I believe, have confidence that the forces pushing in the direction of international economic disintegration will be countered, and that a liberal political and economic order will be the underpinning of the world community in the decade and, indeed, the century ahead. The consequences of setting out on an alternative path are simply too obvious and too appalling. Zbigniew Brzezinski put it well in his recent book:

> Humanity's catastrophic encounter with communism during the twentieth century has thus provided a painful but critically important lesson: Utopian social engineering is fundamentally in conflict with the complexity of the human condition, and social creativity blossoms best when political power is restrained. That basic lesson makes it all the more likely that democracy—and not communism—will dominate the twenty-first century.

And democracy requires as a necessary condition a liberal economic order.

Excerpted from a lecture to the International Industrial Development Foundation, New York City, October 21, 1991. Paul W. McCracken is University Professor Emeritus at the University of Michigan, and former Chairman of the President's Council of Economic Advisers.

Quotable Quote

By Owen Harries

Migration is a looming issue. Large-scale, sustained, and uncontrolled migration from third world countries to the developed industrialized ones, with all the tension and hostility that would entail, is a real prospect.

Unless third world countries make remarkable economic progress, or unless the developed countries can seal their doors very effectively, and both things are very improbable, millions will migrate—driven by misery at home and drawn by the good life that television, and the increasing number of friends and relatives who have gone ahead, will tell them about.

When this happens it can be expected that America, with its tradition of accepting immigrants, will cope reasonably well. Indeed, it is already coping well—for the United States already took in more immigrants in the 1980s than in any previous decade in its history, and 90 percent of them were from third world countries.

On the other hand, a Japan that sets great store by racial purity will continue to exclude immigrants virtually completely, and will solve its labor problems by moving factories to the third world, rather than letting immigrants come to Japan.

As Graham Fuller observes, the region that will be hit hardest by the influx will be Europe, traditionally and until very recently a huge exporter of people, not an importer, and a continent of comparatively homogeneous nationalities. Europe will neither be able to keep immigrants out nor to cope with them when they are in place.

The strains are already clearly evident as a result of the relatively modest numbers—10 million or so—who have already arrived there. Most of these are Muslim and they are not being absorbed into the general population. As the French historian Jean Marie Domenach puts it, "Even as we are integrating all Europe, we can see a Muslim community that cuts across European lines, a sort of thirteenth nation of the European Community." That thirteenth nation will grow rapidly, both because of high birth rates and further heavy immigration. Indications of the politically explosive character of this process are already being given by those leading French politicians from both Left and Right who have decided there are votes in exploiting racial resentment and hatred. And in Germany, the first anniversary of unification in September of this year was marked by widespread riots directed against migrant hostels. The problems will be all the worse, and will be made more complex, because of the virtual certainty that mass South-North immigration will be combined with mass East-West flows.

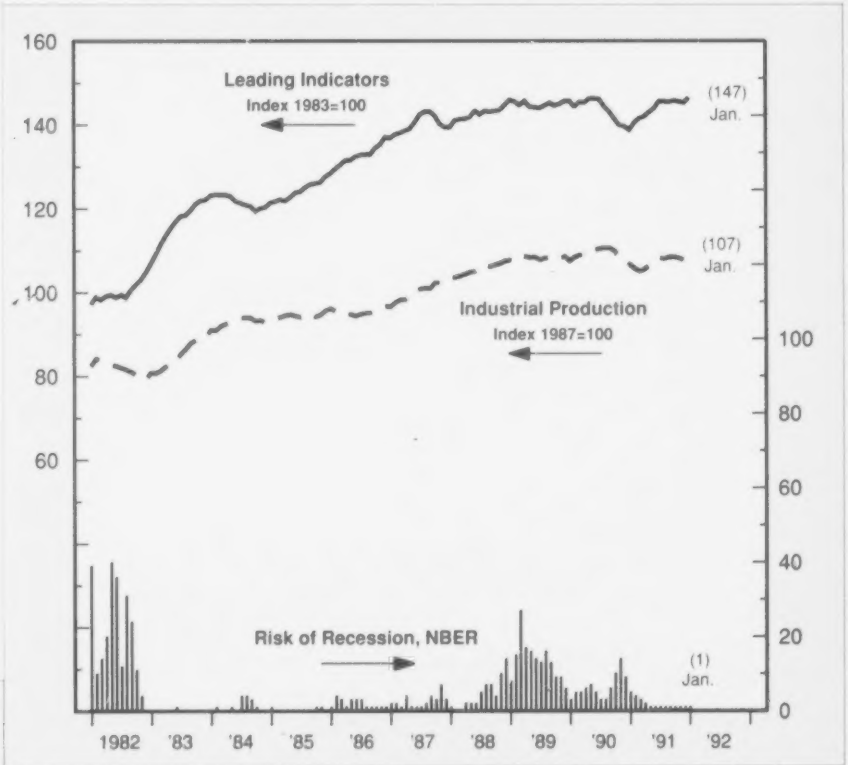
Excerpted with permission. "The Third World, R.I.P.," ©*The National Interest*, No. 26, Winter 1991/92, Washington, D.C. Owen Harries is editor of *The National Interest*.

Conference Board Stat File

Slow Recovery Back On Track

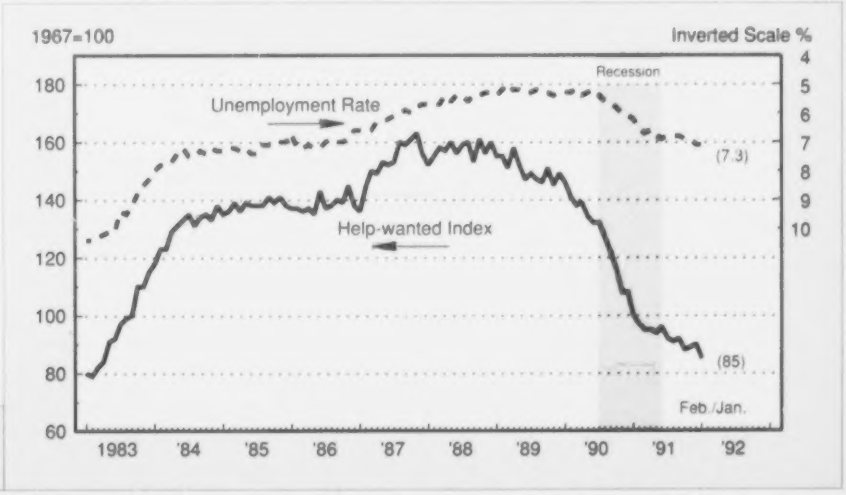
The economic signs and portents are full of inconsistencies and contradictions. The leading indicators (this page) are up nicely at latest reading, supported by the purchasing agents' survey. Yet consumer confidence (page 10), despite a slight improvement in the latest numbers, continues to cast a black cloud over the outlook. On the other hand, favorable expectations dominate the mood of CEOs (page 10), CFOs and business economists. And retail sales rebounded briskly in January and February. But business cycle news from abroad is mostly sour. Also, the U.S. labor market data (this page) remain deeply discouraging. Inflation (page 9), however, is encouraging. On balance, where all this nets out is that the uncertainty about the U.S. business cycle has been resolved, with the much ballyhooed "double dip" recession coming close to reality but proving at the last minute to be an illusion. Consequently, the gradual cyclical recovery that got underway last spring seems to be back on track. But the key word is *gradual*. (Note: Data for Conference Board series in this section are available on request from Ken Goldstein at 212-339-0331.)

Early Warning Indicators



Leading indicators revive a bit.

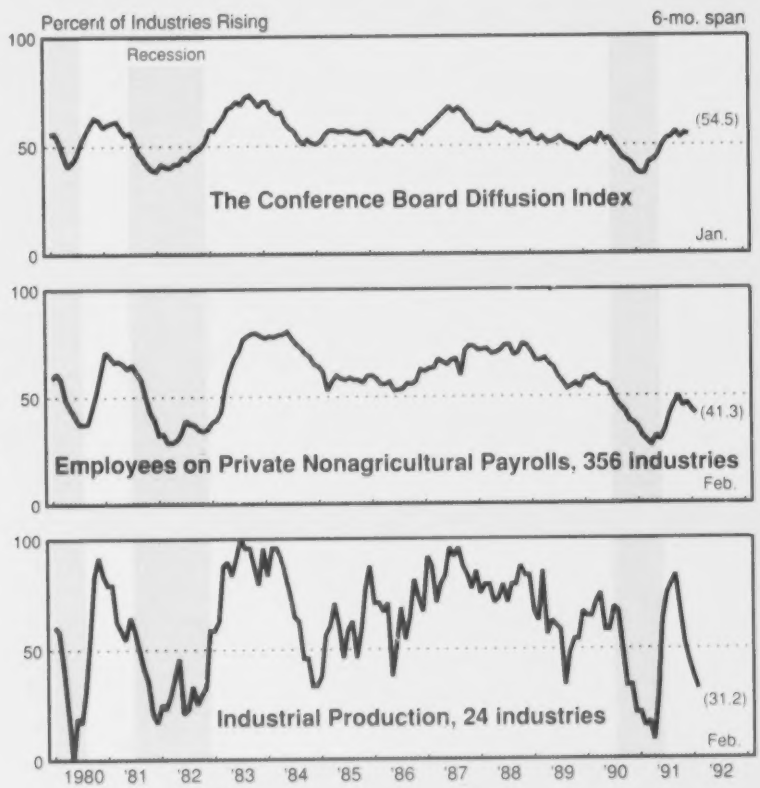
Help-Wanted Advertising and Unemployment



Labor market weakness continues.

Conference Board Stat File

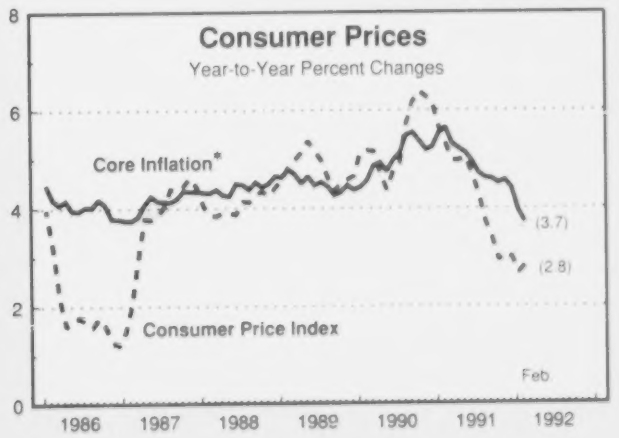
Indexes of Economic Momentum



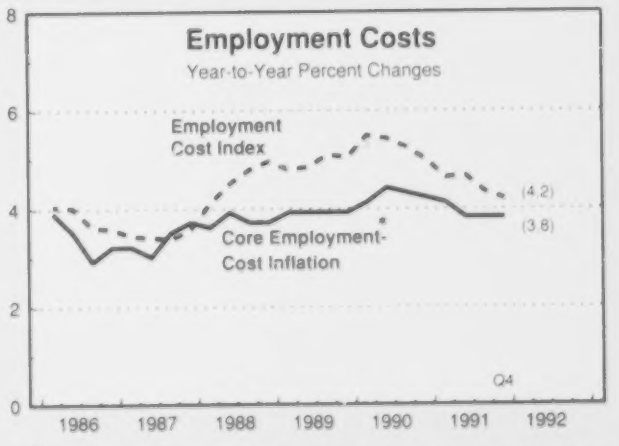
Slowdown persists.

Inflation slower but not vanquished.

Inflation Fundamentals



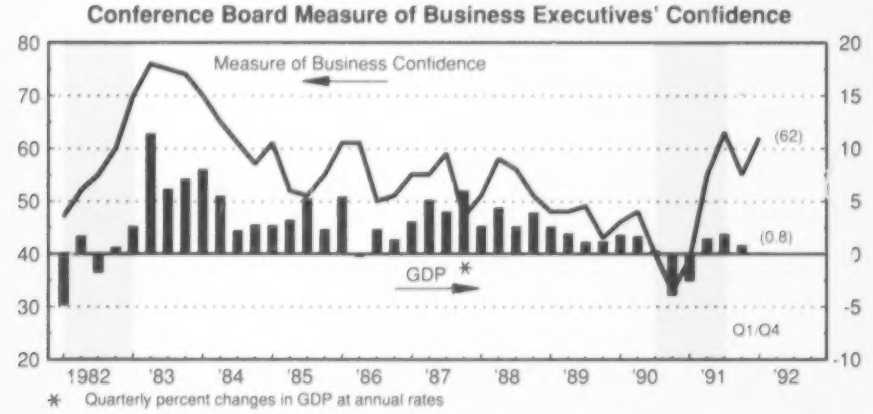
* Core Inflation = CPI excluding food at home and energy.



* Core employment-cost inflation = wages and salaries of private sector workers excluding sales personnel (i.e., excluding the benefits that are part of the ECI).

Conference Board Stat File

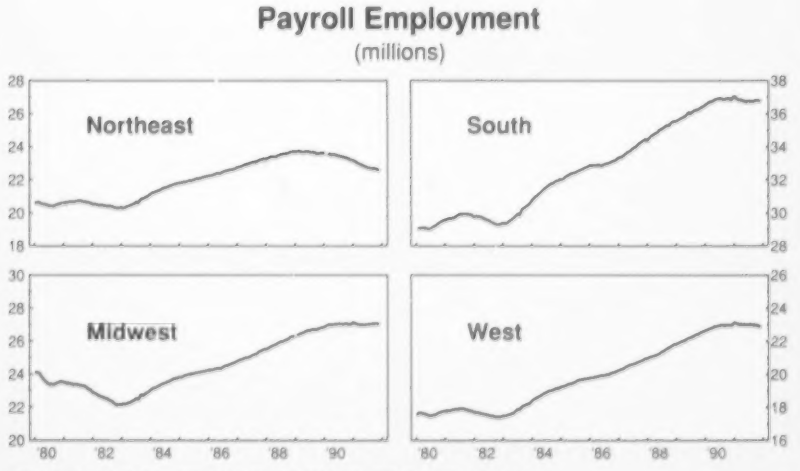
Confidence



Remarkable dicotomy persists between consumers and executives.

Chart of the Month

The regional disparity in this recession has been severe, with the Northeast area taking by far the biggest hit. Indeed, the Northeast accounts for almost 80 percent of the decline in total non-farm payrolls since July 1990.



Source: BLS and C.J. Lawrence Weekly Economic Briefing, March 16, 1992

Inside the Crystal Ball

		UCLA	MERRILL L.	DU PONT	GEORGIA ST.	NORTHERN TRUST	CONF. BOARD	EATON	L.H. MEYER	DRI	WEFA	MICHIGAN - RSQE			
Date of Forecast		Mar.	Mar.	Mar.	Mar.	Mar.	Mar.	Mar.	Mar.	Mar.	Mar.	Mar.			
Gross Domestic Product		(Quarter-to-quarter percent change, constant dollars, seasonally adjusted at annual rates)													
		%	%	%	%	%	%	%	%	%	%	%			
Actual	1991 3Q	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	3Q	1991	Actual
	4Q	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	4Q		
Forecast	1992 1Q	-1.1	0.3	-0.0	0.7	0.3	0.9	1.1	0.0	0.3	-0.9	-0.3	1Q	1992	Forecast
	2Q	1.7	2.4	2.3	2.5	2.3	1.8	2.6	2.4	2.9	2.1	2.3	2Q		
	3Q	2.7	3.4	3.6	4.3	3.3	2.6	3.9	3.1	3.3	3.8	4.2	3Q		
	4Q	2.4	3.2	3.6	3.7	2.9	2.3	3.7	3.2	3.6	3.2	4.8	4Q		
	1993 1Q	3.1	3.1	3.8	2.6	2.9	1.8	3.2	2.8	3.3	3.0	4.7	1Q	1993	
	2Q	3.0	2.7	3.7	3.1	3.0	2.3	2.1	2.7	3.6	3.1	3.8	2Q		
	3Q	3.0	2.9	3.5	2.4	2.9	2.8	2.4	2.8	2.8	3.0	3.4	3Q		
	4Q	2.9	2.8	3.6	1.7	2.5	2.5	3.9	2.6	2.6	3.1	3.3	4Q		
	1994 1Q	2.7					2.2			2.8	3.2		1Q	1994	
Inflation (Deflator)		(Percent change from same quarter one year earlier)													
Actual	1991 4Q	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	1991	4Q	Actual
Forecast	1992 4Q	2.1	3.3	3.4	2.7	3.0	2.7	2.7	2.2	2.9	2.5	2.6	1992	4Q	Forecast
	1993 4Q	3.3	3.6	3.6	3.7	3.2	3.2	2.8	2.6	3.0	3.3	2.9	1993	4Q	
30-Yr Treasury Bond Rate		(Percent, quarterly)													
Actual	1991 3Q	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.2	3Q	1991	Actual
	4Q	7.9	7.9	7.9	7.9	7.9	7.8	7.9	7.9	7.9	7.9	7.9	4Q		
Forecast	1992 1Q	7.8	7.8	7.8	7.8	7.8	7.7	7.8	7.7	7.8	7.8	7.7	1Q	1992	Forecast
	2Q	7.7	7.9	7.7	8.0	7.6	7.8	8.0	7.6	8.1	7.7	7.6	2Q		
	3Q	7.6	8.0	7.5	8.1	7.4	7.8	8.0	7.3	8.0	7.7	7.5	3Q		
	4Q	7.7	8.2	7.5	8.3	7.5	7.8	8.0	7.2	7.9	7.9	7.5	4Q		
	1993 1Q	7.7	8.2	7.5	8.5	7.6	7.8	7.9	7.1	8.3	8.1	7.8	1Q	1993	
	2Q	7.8	8.3	7.5	8.6	7.7	8.1	7.9	7.0	8.4	8.2	7.7	2Q		
	3Q	8.0	8.3	7.5	8.9	7.8	8.1	7.9	6.9	8.5	8.3	7.7	3Q		
	4Q	8.0	8.5	7.5	8.8	7.9	8.1	7.9	6.9	8.6	8.4	7.6	4Q		
	1994 1Q	8.0					8.1			8.5	8.4		1Q	1994	
Unemployment Rate		(Percent, quarterly)													
Actual	1991 4Q	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9	4Q	1991	Actual
Forecast	1992 4Q	7.4	6.8	6.6	7.0	6.8	6.8	6.6	6.7	7.0	7.3	6.9	4Q	1992	Forecast
	1993 4Q	7.0	6.3	6.2	6.6	6.4	6.8	6.3	5.9	6.4	6.7	5.9	4Q	1993	
	1994 1Q	6.9					6.8			6.3	6.5		1Q	1994	

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